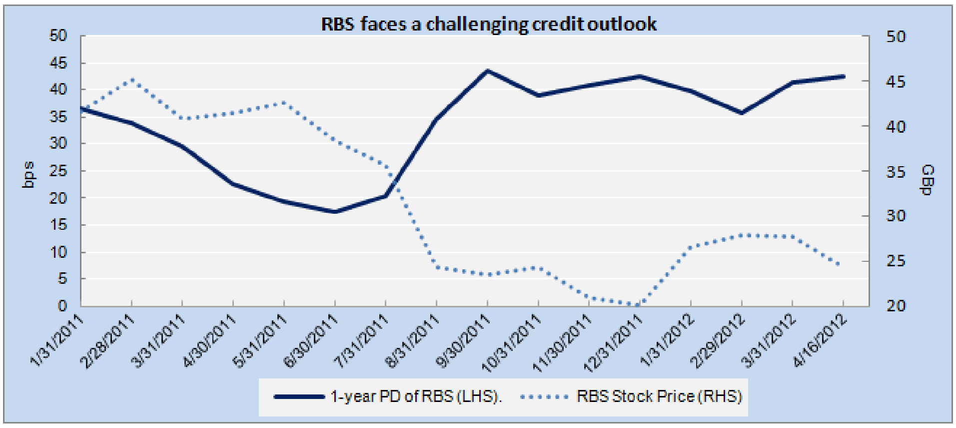
Stories of the Week

RBS's efforts to restore financial health face significant hurdles

A series of business and asset restructurings carried out by the Royal Bank of Scotland (RBS) since its finances collapsed in 2008 have resulted in an improvement in the bank's financial condition. After RBS received around GBP 45bn from a common equity injection by the UK Government in October 2008, the bank has implemented ongoing changes to reduce the risk and size of its global businesses. RBS has shifted its focus to core retail and corporate banking operations based in the US and UK, divested or restructured impaired assets, and cut staff overhead through retrenchments. These changes have been followed by positive market reaction and an improvement in the firm's credit profile.

Released on February 23, the bank's annual report for the year ending December 31, 2011 revealed that RBS's annual operating profit turned positive for the first time since 2008, prompting an immediate 5.1% increase in the bank's stock price on the same day. RBS reported that it believes non-performing loans reached a peak of 6% last year. Together with an easing of the European debt crisis in the past few months, this has contributed to a reduction in RBS's credit risks in recent months. The RMI CRI 1-year probability of default (PD) for RBS fell to 41.4bps on March 31, down from a historical high of 184.3bps in October 2008 and a recent high of 46bps on September 30 last year.

However, evident though it may be, the success of RBS's restructuring strategies, thus far, may not lead to a swift turnaround at the bank. As the RMI CRI PD suggests, the credit outlook for RBS remains unfavorable; after reaching a low of 35.8bps in six months on February 29, RBS' 1-year PD resumed the previous upward trend, climbing to 42.6bps on April 16. We believe a multitude of problems are imperiling the bank's credit outlook: an overall negative profit prospect, due to a weakening economy in the UK and Ireland, compounded by an increasingly difficult operating environment, stemming from the ongoing European debt crisis, as well as the risk of further increases in impaired loan assets.



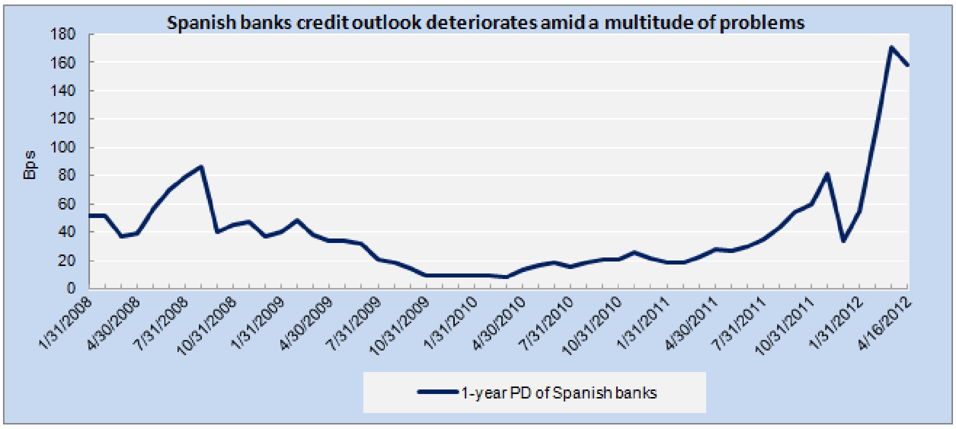
The first issue confronting RBS is the continued deleveraging and cash hoarding by British businesses and consumers since the global financial crisis began four years ago. This has been unfavorable for corporate and retail banking operations of UK-based banks, especially RBS which has made the domestic market a core strategic focus under the current restructuring. Material impacts are evident. According to RBS's 2011 financial statements, the bank's net interest income was GBP 21.4bn for the fiscal year 2011, compared to GBP 22.7bn a year ago and GBP 49.5bn in 2008. Last year marked the third consecutive year of decline in the bank's interest income since 2008.

Adding to this challenge is the risk of a further deterioration in the funding condition of RBS and the UK banking industry at large. In the UK, bank funding continues to be costly despite a de-escalation of the European debt crisis and a continuation of Bank of England's quantitative easing program. The GBP 3-month Libor remained above 1% on April 16, nearing the record high level of 1.08% since the onset of the crisis. Besides impairing bank profits, elevated funding costs also increase the debt-servicing burdens of customers as banks pass on cost increases to customers by hiking interest rates on loans, a move that could lead to higher default rates in bank's loan portfolios. Looking ahead, an intensification of the European debt crisis remains likely, as recently evidenced by renewed investor jitters in the Spanish sovereign debt market; this could wreak havoc on the UK bank funding market.

The last major area of concern for RBS lies in the bank's balance sheet. Firstly, the bank's aggressive asset disposal strategy, which saw a sale of GBP 80bn of RBS assets in 2011 compared to GBP 47bn in 2010, could put future profits at risk. Accelerated asset sales have brought significant losses to the bank, although such strategy has succeeded in reducing the RBS's leverage ratio to 16.9 in 2011 from 28.7 in 2008. It is also expected that downward pressures on profits could be exacerbated further given the uncertainty over global merger and acquisition activities, which saw a sharp quarterly decline of 14% in Q1. At the same time, RBS's effort to return to a net profit could continue to be hamstrung by the poor performance of Ulster Bank, RBS's Ireland-based subsidiary, which has reported consistent losses since 2008 amid a crumbling housing market in Ireland. The weakening Irish property market, which saw house prices continue to tumble last year to the lowest levels since 2000, as well as the country's high unemployment rate, provided a gloomy backdrop for Ulster Bank's mortgage business. It also faces the risk of losses from having to buy back mortgages that it has securitized, and increasing difficulty in selling mortgage securitization deals, due to a new Irish personal-insolvency rules. Another potential pitfall for RBS stems from its moves over the past few years to restructure its non-performing debts through reductions, modifications or even debt to equity swap. While RBS has reduced the level of impaired loans for now, the bank has not eliminated the risk of a potential surge of defaults in the loans that have been restructured, given the dismal outlook for the UK economy.

Sources:
Loan books ease at RBS and Lloyds (FT)
Chief hails RBS progress on asset clean-up (FT)
RBS Annual Results 2011 (RBS Group)
U.K. Consumers Repay Debt, Money Supply Shrinks (WSJ)
'Mortgage timebomb': RBS and NatWest make first move with rate hike for 200,000 customers - Halifax could be next (This is Money)
Global M&A decline in 1st quarter (TheNews)
Ireland's house prices at lowest levels since 2000 (The Guardian)
Ulster Bank reviews 'securitised' mortgages in light of new rules (Irish Independent)

Housing market concerns and reduced government support weigh on Spanish banks' credit outlook



The quarterly results reported last week by Banesto, the fifth largest banking group in Spain, revealed a bleak picture that's clouding the overall picture for the Spanish banking sector. Banesto reported a staggering 88% plunge in the first quarter's net profits from a year ago to EUR 20m, which it attributed to a new government provisioning requirement that was toughened to better prepare Spanish banks for higher real estate loan losses. The more stringent government requirement reflected a continuing deterioration in the Spanish housing market, which has weighed on the credit outlook of Spanish banks since the Spanish housing bubble burst in 2008. The RMI CRI 1-year PD for Spanish banks rose to 170.5bps on March 31 2012, the highest level since the onset of the Spanish housing crisis. Looking ahead, we continue to hold a negative credit outlook for Spanish banks, with RMI CRI 1-year PD for the sector remaining elevated at 158.6 bps on April 16.

The negative outlook is based on a number of qualitative factors. Firstly, a recent rejection by the government of more state aid for Spanish banks, combined with a pessimistic outlook on the banks' access to capital markets, which has been compounded by recent disappointing financial results, are expected to significantly impair the banks' funding ability. Secondly, a continued weakening of the Spanish economy, in particular a soaring unemployment rate creates an adverse backdrop for banks' future profits. Finally, uncertainty over Spanish banks' liquidity condition has been heightened, after the banks grew increasingly reliant on the ECB liquidity and borrowed a record of EUR 316.3bn from the ECB in March.

Sources:
Outlook for Spanish banks dims (FT)
Investors run scared of Spain's battered banks (Reuters)
Spanish banks' reliance on ECB hits record (Reuters)

In the News
Financial stability under threat from lack of safe assets, IMF warns **Apr 11.** The stability of the global financial system is facing threats from a decreasing supply of and a simultaneous surge in demand for safe assets, warned the International Monetary Fund (IMF) last week. The IMF forecasted that available safe assets could decrease by USD 9bn by 2016, or 16% of the current total amount, as more countries face downgrade and could lose their safe status with investors and regulators. The resulting potential safe asset scarcity, combined with the anticipated increase in demand for safe assets, including the rise in demand motivated by regulatory changes, are expected to create adverse impacts on the global financial system. The negative effect includes an intensifying scramble for safe assets among investors that could lead to higher price of safety and a potential degradation in the overall quality of safe assets. (The Guardian)
European companies pick bonds for finance **Apr 12.** Syndicated loan markets, the traditional funding avenue for companies in Europe, have been rapidly shrinking in size in recent months. The value of syndicated loans signed in Europe plunged to EUR

142bn in Q1 this year, the lowest since 2009, while the number of syndicated loan transactions reached the lowest level since 1997. This was largely caused by banks reducing lending to risky companies as part of the “bank disintermediation” phenomenon that arose following the global financial crisis, which has been amplified by the ongoing European sovereign debt crisis. The effects of this phenomenon have led to a surge in bond issuance by European corporates in bond markets. (FT)

Italy forced to pay higher yields on bonds
Apr 12. After a disappointing Spanish debt auction two weeks ago, signs of renewed investor anxiety about the European sovereign debt crisis continued last week. In a bond auction last Wednesday, Italy issued a number of bonds totaling EUR 4.88bn at higher yields than bonds with same maturity dates were sold at a previous auction on March 14. Notably, EUR 2.88bn of three-year bonds maturing in March 2015 were sold at 3.89%, higher than the 2.76% yield the Italian government paid on a three-year bond issued on March 14. (FT, Reuters)

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